Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-8066-98
[redacted]

date: June 8, 1999

to: District Director, [redacted]
Chief, Examination Division
Attn: [redacted]

from: District Counsel, Brooklyn

subject: [redacted]

U.I.L. 162.00-00; 162.21-01

THIS DOCUMENT MAY INCLUDE CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES, AND MAY ALSO HAVE BEEN PREPARED IN ANTICIPATION OF LITIGATION. THIS DOCUMENT SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE IRS, INCLUDING THE TAXPAYER INVOLVED, AND ITS USE WITHIN THE IRS SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW THE DOCUMENT IN RELATION TO THE MATTER OF THE CASE DISCUSSED HEREIN. THIS DOCUMENT IS ALSO TAX INFORMATION OF THE INSTANT TAXPAYER WHICH IS SUBJECT TO I.R.C. § 6103.

BACKGROUND

Reference is made to our memoranda dated January 21, 1999 and January 26, 1999 supplied in response to your requests for advice regarding the above taxpayer. We also supplied you with an additional memorandum dated February 5, 1999 which incorporated the comments made by our National Office specialists upon their review of our earlier memoranda. Subsequently, on April 22, 1999, you requested our views on an analysis set forth in a March 24, 1999 memorandum prepared by [redacted]'s National Office ("the [redacted] Memorandum").

ISSUE

The issue is whether Code section 162(f) bars the deduction of payments made by [redacted] (hereinafter "[redacted]") under civil settlements with the New York State [redacted] (hereinafter "the [redacted]") and the [redacted].

DISCUSSION

The [redacted] Memorandum does not change our views or cause us to alter the recommendations set forth in our memoranda to you dated January 21, 1999 and February 5, 1999. We continue to recommend that you interview personnel who were involved in the settlement and attempt to obtain contemporaneous documents relating to the claims made against [redacted] and the negotiation of the settlement of those claims.

In general, we note that the [redacted] Memorandum is not accompanied by any contemporaneous documents such as correspondence and internal memoranda relating to the claims made against [redacted] and the negotiation of the settlement of those claims. Such documents might reveal facts that would be relevant to the applicability of Code section 162(f) to the settlement payments at issue.

We also note that the [redacted] Memorandum does not clearly identify which of the categories of costs to which each of the arguments contained therein relate. [redacted] incurred three separate categories of costs[1/] and, as is explained in our January 21, 1999 memorandum, we believe the facts and circumstances of each category of costs are sufficiently distinct so that the applicability of section 162(f) to each category must be addressed separately.

Our specific comments with respect to each of the sections of the [redacted] Memorandum are as follows:

Comments With Respect to Analysis of Standards that Apply to Section 162(f)

Sections III.A.-F. of the [redacted] Memorandum contain a discussion of section 162(f) and various concepts that are relevant to the application of that section.

Section III.A. recites the general rule supplied by Code section 162(a) and discusses how Code section 162(f) provides an exception to that rule. These matters are discussed in the first

---

[1] Those three categories are the costs [redacted] incurred to: (1) carry out the detailed plan designed to [redacted] required by paragraph III of the Order on Consent; (2) pay the [redacted] $[redacted] for [redacted] damages as required by paragraph V of the Order on Consent; and (3) pay various [redacted] entities $[redacted] as required by paragraph VII of the Order on Consent.

paragraph on page 5 of our January 21, 1999 memorandum.

Section III.B. discusses the distinction between nondeductible "fines and similar penalties" and deductible "compensatory damages." The section concludes that "nondeductible penalties are those that are punitive in nature" and that "fines that are compensatory or remedial are deductible." We agree with that conclusion. However, as is discussed on pages 6 through 8 of our January 21, 1999 memorandum, we believe it is reasonable given the facts currently developed to take the position that amounts allocated to the settlement of the penalties asserted by the [redacted] were fines or similar penalties rather than compensatory damages.

Section III.C. states that the purpose of a payment must be examined if the statute under which a payment is assessed serves both punitive and compensatory purposes. We note at the outset that it is unclear if that is an accurate statement of the law. In Colt Industries, Inc. v. United States, 880 F.2d 1311, 1314 (Fed. Cir. 1989), the United States Court of Appeals for the Federal Circuit rejected the argument that it should "determine the purpose or purposes served by the specific civil payments at issue in order to ascertain whether the payment is barred from deduction [by Code section 162(f)]." The court noted that neither section 162(f) nor the regulations thereunder prescribed such an inquiry. Even assuming for the sake of argument that is a correct statement of the law, given as is discussed on pages 7 and 8 of our January 21, 1999 memorandum that New York's statutory scheme contains other statutes that appear to perform the compensatory function by obligating [redacted] to [redacted], we are uncertain that the penalty statutes [redacted] was accused of violating may be viewed as serving both punitive and compensatory purposes. Even assuming that the penalty statutes were dual purpose, as is discussed on pages 10 and 11 of our January 21, 1999 memorandum, we believe that amounts allocated to the settlement of the penalties asserted by the [redacted] should not be considered to have served a compensatory purpose.

Section III.D. analyzes two cases for guidance on when a civil penalty will be considered punitive. We acknowledged on page 8 of our January 21, 1999 memorandum that not all payments made in settlement of alleged violations of statutes that label the payments "penalties" are nondeductible under section 162(f). See Stephens v. Commissioner, 905 F.2d 667, 673 (2d Cir. 1990). We then examined on pages 8 through 11 whether amounts allocated to the settlement of penalties asserted by the [redacted] might qualify for an exception to section 162(f) as either penalties imposed to encourage prompt compliance or as penalties imposed to compensate

other parties. We concluded that they did not.

Section III.E. of the [redacted] Memorandum examines two authorities for insight on the meaning of the terms "compensatory" and "remedial." The memorandum examines Mason and Dixon Lines, Inc. v. United States, 708 F.2d 1043 (6th Cir. 1983), for insight on the definition of "compensatory." That case addressed whether liquidated damages paid by a taxpayer for operating overweight trucks in Virginia were compensatory damages. Virginia's regulatory scheme imposed two separate sanctions for violations of its vehicle weight laws: (1) a fine or imprisonment or both under section 46.1-16 of the vehicle weight law, and (2) liquidated damages under section 46.1-342(a). Id. at 1047. The taxpayer had paid both fines and liquidated damages, and had conceded that section 162(f) barred the deduction of the fines. The issue was whether section 162(f) barred the deduction of the liquidated damages.

The court began its analysis by noting that section 46.1-16 subjected the taxpayer to a fine or imprisonment only for violations of the weight laws for which no other penalty was provided. Id. As a result, the court concluded that liquidated damages paid under section 46.1-342(a) could not be a penalty. Id. The court reasoned that the liquidated damages were compensatory in nature because they were based on the amount by which a truck exceeded the weight limit and were graduated so that the damages per pound of excess weight increased as the magnitude of the violation increased. Id. The court observed that this appeared to reflect the fact that damage to highways increases with added weight. Id. Furthermore, the court noted that section 46.1-342(a) required the liquidated damages to be "allocated to the fund appropriated for the construction and maintenance of highways." Id. The court concluded that the language of section 46.1-342(a) had the earmarks of a provision for civil compensatory damages. Id.

The discussion of Mason and Dixon Lines in the [redacted] Memorandum fails to mention that the court concluded that the liquidated damages in that case were not paid to satisfy a penalty. That distinction is a key distinction between that case and [redacted]s case. In this case, there is a factual dispute over whether the $[redacted] paid to the [redacted] was paid in whole or part to settle the penalties that had been asserted by the [redacted].

In addition, we believe the discussion of Mason and Dixon Lines misleadingly overemphasizes the significance of the existence of a fund into which the payment would be directed. We believe

that the use to which the liquidated damages contributed to the fund were required to be put was more important to the court's conclusion that the liquidated damages were compensatory than the existence of the fund.[2/] In this case, there is a dispute over whether use to which the $[redacted] paid by [redacted] to the [redacted] qualified as compensatory.

The [redacted] Memorandum cites PLR 8708004 (Nov. 13, 1986) as authority for the proposition that the term "remedial" includes "monetary exactions in which there is a compensatory or computational nexus between the amount of the exaction and the harm or injury done to the exacting government * * *, or to third parties that the exacting government is attempting to protect." Although that is a quote from the PLR, we do not believe that amounts allocated to the settlement of the penalties asserted by the DEC may be considered "remedial" merely because there may be a nexus between the $[redacted] paid the [redacted] and the harm or injury caused by [redacted]. As is stated on pages 10 and 11 of our January 21, 1999 memorandum, we view the facts relating to this issue as analogous to the facts that were presented in Allied-Signal, Inc. v. Commissioner, 95-1 U.S.T.C. ¶ 50,151 (3d Cir. 1995), aff'g, T.C. Memo. 1992-204. As is explained in the January 21, 1999 memorandum, we believe that case supports the proposition that to be considered remedial, payments must compensate aggrieved parties for the specific losses caused by a taxpayer's misconduct rather than serve a general public purpose (even, as was the case in Allied-Signal, one closely related to the losses). That view is consistent with the statement in PLR 8708004 that immediately follows the statement quoted in the [redacted] Memorandum. That statement is that:

> [w]e do not interpret [the Tax Court's decision in Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136 (1979)] as including within the scope of the term "remedial" those penal or punitive exactions enacted to enforce the law even though such exactions may be aggregated in a fund to mitigate the harm or injury caused by the proscribed action or conduct.

---

[2] See also Allied-Signal, Inc. v. Commissioner, 95-1 U.S.T.C. ¶ 50,151 (3d Cir. 1995), aff'g, T.C. Memo. 1992-204 (holding $8 million settlement not deductible even though paid into fund); PLR 9708004 (Nov. 13, 1986)(concluding that penal or punitive exactions enacted to enforce the law are not remedial even though aggregated in a fund to mitigate the harm caused by the proscribed action or conduct.)

That statement supports the view that payments that serve a general public purpose do not qualify as remedial.

Section III.F. on pages 7 through 9 of the [redacted] Memorandum discusses True v. U.S., 894 F.2d 1197 (10th Cir. 1990). For the reasons explained on pages 7 and 8 of our January 21, 1999 memorandum, we believe that True supports the proposition that amounts allocable to the settlement of the penalties asserted by the [redacted] would be nondeductible under section 162(f).

Comments with Respect to Analysis of Statutes Violated

Section III.G. of the [redacted] Memorandum argues that the statutes upon which the payments were based were "compensatory in nature." Although it is true that some of the statutes that [redacted] was accused of violating were remedial in nature, other statutes referred to in the Order on Consent were penalty statutes. Specifically, paragraphs 13 and 14 of the Order on Consent refer to:

[redacted]

As we explained in the first full paragraph on page 8 of our January 21, 1999 memorandum, New York's statutory scheme contains the above penalty statutes in addition to statutes that impose upon [redacted] the obligation to pay the costs of remediating the spill. In our view, the argument that the statutes upon which the payments were based were "compensatory in nature" overlooks that New York's statutory scheme contains both penalty and remedial statutes.

[redacted] - In arguing on pages 9, 10, and 11 that the purpose of [redacted] is remedial and not punitive, the [redacted] Memorandum fails to acknowledge that [redacted] statutes include both penalty and remedial components. The penalty component contained in the [redacted]. The [redacted] Memorandum fails to mention that

section even though it is referred to in the Order on Consent.

[redacted] - Although the memorandum acknowledges on pages 11 and 12 that [redacted] contains punitive elements, the memorandum fails to mention [redacted] and fails to point out that the standards set forth on the bottom of page 11 are contained only in [redacted]. New York [redacted] contains no such standards.

Comments With Respect to Analysis of Settlement Agreement

The [redacted] Memorandum argues on pages 13 through 17 that [redacted]'s settlement agreement, as set forth in the "Memorandum of Agreement Between [redacted] and [redacted] on [redacted] and Replacement", the "Order on Consent", and the "Settlement Agreement" shows that the payments were not for punitive purposes.

Memorandum of Agreement - This agreement appears to be the Memorandum of Agreement that we recommended in footnote 1 of our January 21, 1999 memorandum that you obtain a copy of. We continue to recommend that you obtain a copy of the memorandum.

Assuming that the memorandum of agreement contains the statements quoted in the [redacted] Memorandum, we do not believe it compels a conclusion that the $[redacted] settlement with the [redacted] would be deductible. The statements indicate that the $[redacted] was to be used to restore and replace natural resources and protect groundwater in [redacted] rather than to compensate for the specific damage caused by [redacted]. We accordingly view this case as analogous to the situation that was addressed in Allied-Signal, Inc. v. Commissioner, 95-1 U.S.T.C. ¶ 50,151 (3d Cir. 1995), aff'g, T.C. Memo. 1992-204. As we explained in the discussion of that case that is contained on pages 10 and 11 of our January 21, 1999 memorandum, it holds that section 162(f) can apply to settlement payments that are intended to be used for general public purposes rather than for compensating aggrieved parties for the specific losses caused by a taxpayer's conduct.

Order on Consent - Section III.H.2. of the [redacted] Memorandum argues that section 162(f) does not apply because: (1) the stated purpose of the Order on Consent is primarily compensatory and remedial, (2) remedial actions taken by [redacted] point to non-punitive payments, and (3) the fact that the agreement is in the

form of an Order on Consent indicates that the payments were compensatory.

We disagree that the stated purpose of the Order on Consent establishes that the purpose of the $[redacted] paid to the [redacted] was remedial. That argument ignores that the the stated purpose includes "resolving and settling the violations alleged" in the Order on Consent, which include violations of the statutes discussed above that provide penalties for [redacted]'s actions. As we explained in our January 21, 1999 memorandum:

> Given that [redacted]'s obligation to pay cleanup and remediation costs appears to have been satisfied by [redacted]'s agreement to carry out the detailed remedial plan called for in paragraph III of the Order on Consent and by its agreement with the [redacted] (assuming [redacted] establishes that the locations to which water mains were to be extended and at which [redacted] was to be monitored and remediated were locations impacted by [redacted]), and in the absence of information otherwise, we believe it is reasonable to take the position that the $[redacted] should be allocated to the settlement of the penalties asserted by the [redacted].

The [redacted] Memorandum argues that [redacted]'s payments were not punitive because it took prompt remedial actions upon discovering the [redacted], the [redacted] recognized that it did so, and the [redacted] accordingly concluded that "punitive fines were inappropriate." We think that argument misstates the relevant question. As we explained on page 2 of our February 5, 1999 memorandum, the critical inquiry is "what the $[redacted] was in lieu of rather than * * * whether the [redacted] decided that it would be appropriate to impose fines."[3/] We explained that if the [redacted] decided not to impose fines because [redacted] agreed to pay the $[redacted], then we believe it would support the conclusion that the $[redacted] should be treated as a fine or penalty.

Finally, we disagree with the argument that section 162(f) does not apply because the payments were made pursuant to a settlement agreement in the form of an order on consent. The only support cited in the [redacted] Memorandum for that proposition is a statement from a 1992 Field Service Advice, a copy of which is

---

[3] See also page 5 of our January 21, 1999 memorandum, where we identify authority for the rule that in analyzing the deductibility of a settlement payment, the critical question is what the settlement was paid in lieu of.

attached hereto, that "[w]ithout more information, it appears that any fines or penalties arising from such consent orders would be deductible under section 162(a)." The [redacted] omits the sentence that follows that quote. The omitted sentence states that "Further factual development is necessary to better understand the nature of the consent orders." The omitted sentence establishes that the National Office had concluded that the facts needed to be developed further to enable it to decide whether section 162(f) applied rather than that section 162(f) could never apply to a settlement paid pursuant to an order on consent. Moreover, interpreting the National Office's comments as stating that section 162(f) cannot apply to payments made pursuant to consent agreements settling charges that taxpayers violated statutes that provide for fines or penalties would be contrary to the Treasury regulation that provides that fines and penalties for purposes of section 162(f) include amounts "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal) * * *." See Treas. Reg. § 1.162-21(b)(1)(iii).

Settlement Agreement - The [redacted] notes on pages 15 and 16 under section III.H.3.(1) that the payments at issue were made under a settlement agreement. That fact does not prevent the application of section 162(f). As was noted immediately above, fines and penalties for purposes of section 162(f) include amounts "[p]aid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal) * * *." See Treas. Reg. § 1.162-21(b)(1)(iii).

The [redacted] Memorandum notes on page 16 under section III.H.3.(2) that there is a connection between the amount of the damage caused by [redacted] and the amount of its payments and that the connection indicates that the payments were compensatory in nature. We agree that there appears to be a connection between the amounts of damage caused by [redacted] and (1) the amount it was required to pay to carry out the detailed plan designed to remediate the [redacted] required by paragraph III of the Order on Consent, and (2) the $[redacted] it was required to pay under its agreement with the [redacted].[4/] However, we do

---

[4] We recommended in footnote 2 of our January 21, 1999 memorandum that you determine whether the locations to which [redacted] were to be extended and at which [redacted] was to be monitored (and if necessary remediated) were locations impacted by [redacted]. Our conclusion that there appears to be a connection between the amounts of damage caused by [redacted] and the $[redacted] it was required to pay under its agreement with the

not believe that [redacted] has established the connection between the amount of damage it caused and the $[redacted] it agreed to pay the [redacted]. Furthermore, even assuming [redacted] were to establish such a connection, we are unconvinced that the $[redacted] was used to compensate aggrieved parties for the specific losses caused by [redacted]'s conduct rather than simply for a general public purpose. See page 5 of this memorandum and pages 10 and 11 of our January 21, 1999 memorandum.

The [redacted] Memorandum notes on page 16 under section III.H.3.(3) that [redacted]'s agreement with the [redacted] provides that if the ownership of [redacted] changed before it met its payment obligations under the agreement, then the [redacted] would have the option of accepting the new owner of [redacted] as the obligor for the remaining obligations. The [redacted] concludes that that provision suggests that [redacted]'s payment obligation to the [redacted] was not a punitive fine. Although we do not believe the cases cited in the [redacted] Memorandum support that proposition, we also note that this argument is relevant only to the application of section 162(f) to payments made under [redacted]'s agreement with the [redacted]. We had concluded in our January 21, 1999 memorandum that if [redacted] establishes that the locations to which water mains were to be extended and at which [redacted] was to be monitored and remediated under that agreement were locations impacted by [redacted], the circumstances would indicate that section 162(f) does not bar the deduction of [redacted]'s payments under that agreement.

The [redacted] Memorandum states on page 17 under section III.H.3.(4) that in Mason and Dixon Lines, Inc. one of the factors that caused the court to conclude that liquidated damages paid by a taxpayer for operating overweight trucks in Virginia were compensatory was that they were paid into a fund used to construct and maintain Virginia's highways. We do not view Mason and Dixon Lines, Inc. as standing for the proposition that the liquidated damages were deductible merely because they were paid into a fund. Indeed, Allied-Signal demonstrates that payments are not made deductible merely because they are paid into a fund. We view as more important to the court's holding in Mason and Dixon Lines, Inc. its conclusions that the liquidated damages were not penalties and that the liquidated damages were to be devoted to the construction and maintenance of roads in Virginia, thereby remedying the specific damage caused by the operation of overweight trucks.

[redacted] assumes that the locations were impacted by [redacted].

As was the case in Mason and Dixon Lines, Inc., [redacted]'s actions subjected it to both damages (for cleanup) and penalties. However, in contrast to Mason and Dixon Lines, Inc., the issue in this case is whether any of [redacted]'s payments are allocable to penalties. As we noted in our January 21, 1999 memorandum, [redacted]'s obligation to pay cleanup and remediation costs appears to have been satisfied by [redacted]'s agreement to carry out the detailed remedial plan called for in paragraph III of the Order on Consent and by its agreement with the [redacted] (assuming [redacted] establishes that the locations to which water mains were to be extended and at which [redacted] contamination was to be monitored and remediated were locations impacted by [redacted]. Given that [redacted]'s obligation to pay cleanup and remediation costs appears to have been satisfied by other aspects of the settlement and in the absence of information otherwise, we continue to believe it is reasonable to take the position that the $[redacted] should be allocated to the settlement of the penalties asserted by the [redacted].

You should be aware that, under routine procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary. If you have any questions, you should call Halvor Adams at (516) 688-1737.

DONALD SCHWARTZ
District Counsel

By: _____
JODY TANCER
Assistant District Counsel

Attachment: Field Service Memorandum dated September 28, 1992

cc: Revenue Agent Larry Kiss

3RD DOCUMENT of Level 1 printed in FULL format.

1992 FSA LEXIS 199

[NO DISCLAIMER IN ORIGINAL]

Environmental Protection Fines

September 28, 1992

REFERENCE: [*1] CC:TL-N-8543-92, FS:IT&A:MAlonso-Perez

TEXT:
September 28, 1992

to: District Counsel, Atlanta CC:ATL Attn: Clinton M. Fried, Senior Attorney

from: Assistant Chief Counsel (Field Service) [*2] CC:FS

subject: Environmental Protection Fines

This responds to your request for field service advice dated June 25, 1992, regarding to deductibility of fines and penalties asserted for violation of environmental laws. Our discussion represents an overview of the law in this area. Further factual development on specific fines and penalties will be necessary before definite conclusions can be reached.

ISSUE

Whether fines and penalties asserted for violation of environmental laws by the United States Environmental Protection Agency and the Georgia Environmental Protection Division are nondeductible fines or penalties under *I.R.C. § 162(f)*.

CONCLUSION

The deductibility of fines and penalties asserted for violation of environmental laws is determined by the nature of the payment. A fine paid or incurred in carrying on a business is deductible if the payment is exacted for a compensatory or remedial purpose. The fine paid is not deductible if the payment is exacted for punitive purposes. Specific factual development will be necessary to determine the nature of the payments in question.

FACTS

Your request states that an Information Gathering [*3] Project has been approved on Hazardous Waste Sites to determine the degree of compliance in the industry, and it is your understanding that the U.S. Environmental Protection Agency (EPA) and the Georgia Environmental Protection Division are assessing fines/penalties on the responsible parties for violations of environmental laws.

Your request does not set out in detail the various scenarios that give rise to the fines and penalties. However, you do state that the fines and penalties can result from, or, are in the form of consent orders, treble damages, failure to respond to certain letters, fees charged if EPA workers have to perform the

actual cleanup themselves (charging the company for the number of hours involved), etc. You indicate that many times there are negotiated settlements between EPA and companies for the cleanup of the sites. Our overview of the law in this area of fines and penalties is set forth in the discussion below. The specific facts regarding the application of fines and penalties in cases in your region should be developed and further advice requested if necessary.

DISCUSSION

In general, section 162(a) provides a deduction for "all the ordinary and necessary [*4] expenses paid or incurred during the taxable year in carrying on a trade or business * * *." Prior to 1969, the deduction of trade or business expenses under section 162(a) was also limited by the same judicial gloss that precludes loss deductions when their allowance would frustrate a sharply defined public policy. In 1969, as part of the Tax Reform Act of 1969, Pub. L. No. 91-192, 83 Stat. 487, Sec. 902(a), Congress enacted section 162(f), thereby precluding trade or business expense deductions for fines and penalties resulting from statutory violations.

Section 162(f) provides as follows:

(f) Fines and penalties.--No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

The legislative history of section 162(f) indicates that the measure was intended to codify prior court decisions disallowing on public policy grounds trade or business expense deductions for fines and penalties resulting from statutory violations. n1 See *Colt Industries, Inc. v. United States, 880 F. 2d 1311, 1313 (Fed. Cir. 1989)*. As stated in the Senate Report accompanying the enactment of section [*5] 162(f) (S. Rep. No. 91-552, 91st Cong., 1st Sess. 274 *(1969-3 C.B. 423, 597)*:

First, the committee amendments provide that no deduction is to be allowed for any fine or similar penalty paid to a government for the violations of any law. This provision is to apply in any case in which the taxpayer is required to pay a fine because he is convicted of a crime proceeding in an appropriate court. This represents a codification of the general court position in this aspect.

- - - - - - - - - - - - - - - - - - -Footnotes- - - - - - - - - - - - - - - - - - -

n1 In enacting Section 162(f), Congress intended to preempt the field where trade or business expenses are concerned. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 274 *(1969-3 C.B. 423, 597)* ("The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive"); *Adolf Meller Co. v. United States, 600 F. 2d 1360 (Ct. Cl. 1979)*. The judicial gloss limiting deductions when their allowance would frustrate public policy is still viable in determining the deductibility of losses under section 165. *Rev. Rul. 77-126, 1977-2 at 48.*

- - - - - - - - - - - - - - - - - - -End Footnotes- - - - - - - - - - - - - - - - - -
[*6]

Thus, section 162(f) was added to the 1954 Code by section 902(a) of the Tax Reform Act of 1969, Pub. L. 91-172, to codify the "public policy doctrine." The public policy doctrine provided that denial of a loss or expense deduction was required by public policy if such deduction arose from the commission of acts forbidden by statute (or omission of acts required by statute) subjecting those guilty to civil or criminal sanctions. The rationale for the denial of tax deductions for payments incident to statutory violations was that such deductions would mitigate the penalty or punishment imposed and thus prove, in effect, to be a disincentive to compliance with the law. See, e.g., *Hoover Motor Express Co. v. United States, 356 U.S. 38 (1957)*, reh'g denied, *356 U.S. 934 (1958)* (disallowing deductions claimed by taxpayers for fines and penalties imposed upon them for violating state penal statutes on the grounds that such deductions would "severely and directly" dilute the actual punishment).

Reg. § 1.162-21(b) provides, in relevant part, as follows:

(1) For purposes of this section a fine or similar penalty includes an amount-- [*7]

(i) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;

(ii) Paid as a civil penalty imposed by Federal, State, or local law; [or]

(iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal).

However, compensatory damages paid to a government do not constitute a fine or penalty. Reg. § 1.162-21(b)(2). In addition, the amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosection or civil action penalty. Id. Consequently, such fees and expenses will be treated as ordinary and necessary business expenses deductible under section 162(a).

Generally, a "fine" is a payment imposed for violating a specific statute or regulation. A "similar penalty" is a payment imposed to enforce the law and to punish those who violate it. It is clear from the legislative history that section 162(f) is intended to apply to civil as well as criminal penalties. However, it appears that section 162(f) was intended to apply only to statutory violations. Specifically, the Senate Report states as follows: [*8]

In approving the provisions dealing with fines and similar penalties in 1969, it was the intention of the committee to disallow deductions for payments of sanctions which are imposed under civil statutes but which in general terms serve the same purposes as a fine exacted under a criminal statute.

S. Rept. No. 92-437, 92d Cong., 1st Sess. 73-74 (1971), *1972-1 C.B. 559, 600* (emphasis added).

Section 162(f) disallows a deduction for civil penalties that are imposed for purposes of enforcing the law and as punishment for the violation of such laws. However, some civil payments, although labeled "penalties," are deductible if imposed to encourage prompt compliance with a requirement of law or as a remedial measure to compensate another party. *Waldman v. Commissioner, 88 T.C.*

1384, 1387 (1987), aff'd, *850 F.2d 611 (9th Cir. 1988); Huff v. Commissioner, 80 T.C. 804, 824 (1983); Southern Pacific Transportation Co. v. Commissioner, 75 T.C. 497, 646-654 (1980);* and *Allied-Signal, Inc. v. Commissioner, T.C. Memo. 1992-204.* [*9] Where a payment ultimately serves each of these purposes, i.e., law enforcement (nondeductible) and compensation (deductible), it is necessary to determine which purpose the payment was designed to serve. *Waldman, 88 T.C. at 1387;* and Allied-Signal, Slip Op. at 33. For example, in *Stephens v. Commissioner, 905 F.2d 667 (2d Cir. 1990),* rev'g and remanding, *93 T.C. 108 (1989),* the court held that while the restitution payments made by taxpayer constituted deductible compensatory payments, the fines paid as part of his punishment were not deductible. See also, *Mason and Dixon Lines Inc. v. United States, 798 F.2d 1043 (6th Cir. 1983)* (court held that fines for trucking violations were punitive and not deductible, but liquidated damages payments were compensatory, and thus deductible).

Generally, the characterization of a settlement payment by the parties to a settlement agreement will be given effect by the courts. Thus, the characterization of the fines or penalties by the parties to a settlement agreement, rather than the character of the original claims [*10] to which such settlement payment relates, determines the deductibility of such payments. *Middle Atlantic Distributors Inc. v. Commissioner, 72 T.C. 1136, 1145 (1979),* acq. *1980-1 C.B. 1; Grossman & Sons, Inc. v. Commissioner, 48 T.C. 15, 29 (1967);* and *Rev. Rul. 80-334, 1980-2 C.B. 61.* If, for example, settlement payments were made in exchange for the termination of criminal, as well as civil proceedings, further factual development would be necessary to determine whether and to what extent such settlement payments would be allocable to nondeductible criminal fines or penalties.

Given this overview of the law regarding fines and penalties, the question now is whether the fines and penalties arising from the situations you set forth in the facts are nondeductible. Of course, more specifics are needed to make definite conclusions. At this point, however, we will provide your with our tentative views.

Apparently, fees are charged if EPA workers have to perform the actual cleanup themselves (charging the company for the number of hours involved). On its [*11] face, these fees appear to be payments exacted for a compensatory or remedial purpose and would therefore be deductible under section 162(a). However, more information is needed on the specific violations involved and the specific terms of the arrangement between the EPA and the company before a definite conclusion can be reached with regard to these fees.

With respect to treble damages, there is specific provision in the Code that prevents a taxpayer from deducting two thirds of the amount paid to satisfy the judgment or in settlement of a suit brought under section 4 of the Clayton Antitrust Act. *I.R.C. § 162(g).* However, there is no similar provision in the Code relating to treble damages with respect to violations of environmental laws. Nevertheless, even though there is no specific provision in the Code, we believe that an argument may be made that two thirds of any treble damage amount paid to satisfy the judgment or in settlement of a suit brought under an environmental law could be considered punitive in nature and therefore nondeductible. Our view is tentative at this point and further information about the particular statutory provision [*12] dealing with treble damages for violation of an environmental law would need to be evaluated before a definite

conclusion can be made.

The fines or penalties resulting from failure to respond to certain letters appear on their face to be payments exacted for punitive purposes and would therefore be nondeductible under section 162(f). Again, however, we do not know what the specific facts are surrounding these particular fines or penalties. It would be helpful if there was further factual development.

We are not sure how any fines or penalties arise from consent orders. Generally, a consent order has the consent of the parties and is in the nature of an agreement of the parties. It is an admission by them that there has been a just determination of their rights. Without more information, it appears that any fines or penalties arising from such consent orders would be deductible under section 162(a). Further factual development is needed to better understand the nature of the consent orders.

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document [*13] should not be disclosed to anyone outside the IRS, including the taxpayer involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed herein. This document also is tax information of the instant taxpayer which is subject to *I.R.C. § 6103*.

If you have any further questions, please call Milagros Alonso-Perez at (202) 622-7920.

DANIEL J. WILES

By: CLIFFORD M. HARBOURT, Senior Technician Reviewer, Income Tax and Accounting Branch, Field Service Division